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## Increased Tax Reporting Requirements for Domestic Disregarded Entities Wholly Owned by Foreign Persons

On Dec. 13, 2016, the U.S. Department of the Treasury issued final regulations to Internal Revenue Code (Code) sections 6038A and 7701. These regulations impact Form 5472 (Information Return of a 25 percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) reporting requirements for foreign-owned domestic single-member LLCs that have not elected to be treated as corporations for U.S. tax purposes. The U.S. Department of the Treasury promulgated the regulations to address situations where a disregarded entity and its foreign owner are not required to file any U.S. tax returns or information returns. For example, if a disregarded entity receives only portfolio interest income or U.S. source income that is fully withheld at source and the foreign owner of the entity is not engaged in a U.S. trade or business, no return must be filed by either the entity or the owner. This hindered the Internal Revenue Service's (IRS) ability to track income for U.S. tax purposes and also made it difficult for the United States to provide information to carry out its information exchange obligations with other governments.

To ensure that the IRS and other law enforcement agencies have access to information regarding foreign-owned domestic single-member LLCs, the new regulations treat a disregarded entity as a corporation for purposes of Code section 6038A if the entity is a domestic entity and one foreign person has direct or indirect sole ownership of the entity. On a practical level, the regulations require the foreign owner of a domestic single-member LLC to report his transactions with the LLC on a Form 5472, including contributions to and distributions from the LLC, interest paid and received, and amounts loaned or borrowed from the LLC. The LLC must file a Form 5472 for each related party with whom the LLC engaged in reportable transactions during the taxable year. For purposes of Code section 6038A, a foreign related party includes, among others, the following foreign persons:

- (1) any direct or indirect 25-percent shareholder of the corporation,
- (2) family members of a direct or indirect 25-percent shareholder of the corporation (such as his brothers and sisters, spouse, ancestors, and lineal descendants),
- (3) a fiduciary of a trust and a beneficiary of such trust, and

(4) two corporations which are members of the same controlled group.

For example, assume a Colombian individual forms a domestic single-member Delaware LLC in Year 1 with the intent to treat it as a disregarded entity for U.S. federal tax purposes. The Colombian individual contributes \$1,000,000 in cash to the LLC upon formation and the LLC uses the funds for its operating activities. In the same year, the LLC recognizes a net profit on its activities and issues a \$100,000 dividend to the Colombian individual. Later that year, the LLC loans \$250,000 to the Colombian individual's brother who is neither a U.S. citizen nor a U.S. resident-alien. In this hypothetical, although the LLC is a disregarded entity for U.S. federal tax purposes and is not required to file its own income tax return, the regulations treat the LLC as a corporation requiring the LLC to file a Form 5472 to report the contribution, dividend and loan in Year 1.

In order to file a Form 5472, the LLC must obtain an employer identification number from the IRS. For each Form 5472, the Form must include (1) the name, U.S. tax identification number, if applicable, and address of the related party, (2) the nature of the related party's business and its principal place of business, (3) each country in which the related party files an income tax return as a resident under the tax laws of that country, (4) the relationship of the LLC to the related party, (5) the name, address, and U.S. taxpayer identification number for the reporting corporation, (6) the reporting corporation's total assets, (7) the places where it conducts its business, (8) its principal business activity, and (9) the name of all direct and indirect 25-percent foreign shareholders, among other information. The information reported on a Form 5472 is not available to the general public but is available to the IRS and other government agencies if the disclosure of information is authorized under Code section 6103. In addition, the United States can also exchange the information on the Form 5472 pursuant to tax treaties, protocols, and tax information exchange agreements under Code section 6103.

In addition to reporting obligations, the LLC has a record maintenance requirement under Code section 6038A for transactions with foreign related parties. It is required to keep (1) original entry books and transactional records, (2) profit and loss statements, (3) pricing documents, (4) any foreign country and third party filings relevant to the related transactions, (5) ownership and capital structure records, and (6) records of loans, services and other nonsales transactions, among others. Failing to file a Form 5472 may result in a \$10,000 penalty for each form the reporting corporation was required to file. This penalty also applies if the reporting corporation fails to comply with the record maintenance requirements under Code section 6038A. Criminal penalties may also apply if the reporting corporation files false or fraudulent information on a Form 5472.

Taxpayers who are concerned about their potential reporting obligations under these regulations should consult with competent tax counsel to determine whether they will have a Form 5472 obligation for the 2017 tax year.

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